TESTIMONY

OF

STEVEN C. PRESTON

ADMINISTRATOR

US SMALL BUSINESS ADMINISTRATION

HEARING ON

LEGISLATIVE PROPOSALS FOR

SMALL BUSINESS INVESTMENT PROGRAMS

BEFORE THE

COMMITTEE ON SMALL BUSINESS

US HOUSE OF REPRESENTATIVES

SEPTEMBER 6, 2007

Chairwoman Velazquez, Ranking Member Chabot, Members of the Committee, good morning. My name is Steve Preston, Administrator of the Small Business Administration. Thank you for giving me the opportunity to testify on potential legislative changes to the Small Business Investment Company programs at SBA.

Since its inception in 1958 SBA's SBIC program has invested over $50 billion in over 100,000 small businesses, a record of over forty years of performance as part of the Nation's economy. The debenture program has formed the backbone of this investment and has operated without cost to the taxpayer, aside from administrative expenses, for the last seven years.

In 2006 alone, SBIC debenture licensees invested over $1.2 billion, and the SBA issued $400 million in further commitments. Currently, approximately 25% of debenture funding goes to Low and Moderate Income (LMI) areas, amounting to nearly $310 million in investments in LMI areas last year.

Despite these numbers SBA has continued to focus on making capital even more available to small business in low and moderate income (LMI) areas. SBA continues to reach out to our licensees and the venture capital community in order to target more debentures to underserved markets and help create sustainable economic growth in areas with the greatest need.

Over the past year the Investment division has developed and implemented an outreach plan dedicated to increasing our reach into the underserved markets of our Nation. This plan has the following primary objectives:

1. **Attract qualified and appropriately structured firms.**
2. **Invest in "Emerging" Managers**
3. **Educate Potential Limited Partners: Institutions and Community Reinvestment Act (CRA) Investors**

To accomplish these goals the investment division has developed, and disseminated improved guidelines for fund structures & strategies that improve the fit for LMI debenture leverage, and revised the Management Assessment Questionnaire (MAQ) to better suit these Debenture program applicants. They have also used SBIC internal data and outside sources (including the Urban Institute Study) to develop a marketing presentation geared toward attracting new fund managers and limited partners.

In December of last year the division hosted a symposium titled "Access to Venture Capital for Women and Minority Entrepreneurs" at SBA's headquarters. Key leaders in private equity and venture capital came to help SBA develop a plan to better serve the needs of women and minorities.

In the past year the Investment division has made presentations to members of the Executive Committee of the California Hispanic Chambers of Commerce (CHCC), senior officials from CalPERS and CalSTRS, The Institutional Limited Partners Association (ILPA), the National Association of Investment Companies (NAIC), the Alternative Investing Summit East and other venues with the specific focus on increasing minority participation in the SBIC program and increasing SBIC investment in underserved markets.

In addition, based on experience from a 2006 CRA event in Philadelphia, the Investment Division is working with both the Federal Reserve Bank and the Federal Home Loan Bank of Chicago to plan a Midwestern conference to educate CRA-focused entities about the SBIC Program and the potential investment opportunities amongst SBICs in formation. The division is also re-opening dialogue, through one-on-one meetings with the member banks of the Small Business Investment Alliance ("SBIA"), an association of large CRA oriented bank investors with a history of investing in SBICs.

SBA also continues to aid underserved markets through the New Markets Venture Capital program (NMVC) which has made over $47 million in equity investments in 55 portfolio companies over the last five years. To date, the New Markets Programs has created over 400 new jobs in addition to approximately 1,100 jobs retained in Low Income (LI) areas across fifteen states and the District of Columbia.

NMVC Companies (NMVCCs) have also provided over $10 million in operational assistance to over 170 actual and/or potential portfolio companies in their targeted geographic areas. While this program is unique in that the fund managers of NMVCCs receive grant funding to provide operational assistance to actual and/or potential portfolio companies to reduce the risk of investing in these nontraditional areas these dollars do not necessarily equate with success.

To date, none of our NMVCCs have repaid their debentures and the record of exits from investments is small. Despite five years of investing this amounts to only one sixth of the impact of one year of SBIC debenture funding in LMI areas, and licensees have not invested the full amount of leverage available. I should also add that the cost of this program is approximately 30 cents for each dollar invested, based on the combination of the operational assistance grants and the credit subsidy cost of the program.

Nevertheless, SBA intends to continue supporting and managing the New Markets program and we will assess the future potential of this program as investment results become clearer.

At the same time, a separate private equity funding mechanism –angel investing -- has been growing. This mechanism has always existed, but until the late nineties it received little public attention.

As the nation's economy shifted towards a more entrepreneurial economy, angel investing has emerged as a significant funding source. According to the 2006 report from the University of New Hampshire Center for Venture Research (UNH-CVR) the angel investor market is now 25.6 billion dollars, up 10.8 percent in the last year alone, and angel investing has been steadily growing since 2001.

While the angel investment market deserves attention as a source of critical seed capital for entrepreneurs, the Administration believes that stable pro-investment policies are a more effective method of encouraging angel activity than government programs. Over the past five years, angel investment has grown from $15.7 billion in 2002 to the current $25.6 billion, a 65 percent increase that has cumulatively created over 540,000 jobs in the last three years alone. (Source-UNH-CVR)

The Administration believes that the best way to strengthen this engine for small business is not through government involvement in its funding, but rather through creating an economic framework that encourages investment at all levels through broad based and reasonable tax rates, and reduced regulatory impediments to the flow of that capital. The Administration firmly believes that this economic policy has been a factor in the rebound of the angel investor sector after it fell from $30 billion in 2001 to $15.7 billion in 2002.

I would now like to turn to the draft legislation that has been forwarded to the SBA for comment. Let me begin with the proposals regarding the Debenture program.

DEBENTURES

SBA has no opposition to many of the proposed changes in Title I of the bill. We believe that these changes can help clarify certain unwieldy requirements in the current program without increasing risk to program performance.

However, SBA believes that either the current tiered structure should remain in place or the maximum amount of leverage be limited to two tiers. SBA has the regulatory ability to limit the tiers to two times regulatory capital, but we are concerned that licensees will view the statutory limit as an entitlement.

A third tier would increase the risk profile in the program and adversely affect subsidy costs. Many debenture funds receive current income and periodic returns of capital and have reinvestment capability thereby mitigating the need for a third tier.

SBA also believes that these changes should have little or no negative cost impact on the SBIC program. In fact, we believe that the less complicated rules regarding leverage and aggregate investment should encourage funds to look in the direction of the SBIC program.

SBA has some concerns, however, regarding Section 102 of the bill. We believe that the language targeting distressed communities and underserved rural and urban areas already in the Small Business Investment Act accomplishes the demographic effect desired. SBA is concerned with the possibility of unduly restricting the investment decisions of SBIC licensees through the inclusion of a "socially or economically disadvantaged" definition.

NEW MARKETS VENTURE CAPITAL

While the initial results of the New Markets program may appear promising, in terms of dollars invested, it would be premature to judge the program's overall effectiveness. The six NMVCCs are in the "investing" stage of their investment plans. To date none of the NMVCCs have been required to start making payments on their debentures, which have interest deferred for the first five years. Until the NMVCCs have started the "harvesting" stage of their life cycles and are required to make payments on their debentures, SBA cannot judge the individual performance of the NMVCCs or the overall performance of the NMVC program.

The goals of the program remain laudable, but the Administration has a legitimate concern that, in a situation where we have little or no repayment history, any changes or further funding would not be prudent. Furthermore, as stated above, the existing debenture program has an excellent record of investment in low and moderate income communities with nearly $310 million invested last year alone.

ANGEL INVESTORS

Turning now to the Angel Capital provisions of the bill the Administration believes the establishment of an on-line database for angel investment would be redundant; there are already at least four such websites in existence including the Angel Capital Association's. That information is a readily available tool for small businesses seeking financing.

Further, while the Administration believes in encouraging private investment in small business, we cannot support the subsidy proposed in the bill. Angel investing represents venture capital in its purest form – individuals using the capital at their disposal to foster business growth without the potential distortions and complexities involved in government intercession.

The draft legislation appears to have only a requirement that angel funds be "accredited" and have made investments, without consideration for the angel group's success at growing companies. Assuming that an "angel group" is actually an "angel investment fund" typically the angel investors comprising the fund are allowed to invest side by side. Further, the program structure presents a potential conflict. Because the SBA injection will be limited to $2 million per group, when portfolio companies require follow-on capital, the angel investors could potentially create deals allowing them to increase their returns at the expense of the SBA investment.

Angel investment is clearly equity funding, and because the draft legislation indicates that the government would only receive a share in the profits, if any, this provision would of necessity have a 100% credit score for funding purposes. However, I must point out that the draft bill does not indicate any repayment of proceeds should the investment <u>not</u> be profitable.

For example, suppose the private investors put in $1 million and used $1 million of Government financing, and ultimately the investment took a 50% loss, so that the total proceeds ended up at only $1 million. Under this proposed legislation there does not appear to be any return of the Government's share of the $1 million invested. What happens to the $1 million in proceeds? Does it all go to the angel investors? If so, in this example, the Angel investors would be made whole from the Government grant proceeds. (It should be noted that many unprofitable investments are not a 100% loss.) As shown in the example, the government capital could take the first tranche of risk and the angel capital could potentially be returned. In effect, the Government is giving money to accredited angel investors.

SBA assumes that the risk is to be shared *pari passu* but even so, it is not clear if the profit is calculated on the portion of the investment funded by the angel group or on the total investment including the government's share.

Some of the Administration's more specific concerns are:

1. Sec 381 (1) states that the angel group needs to be organized, but what is meant by "organized"? Angel investors are really just wealthy individuals. There is no requirement for competent investing or management expertise beyond the individual's personal success. Also, the experience mentioned in section 382 (b)(1) is not required to be successful experience.

2. Section 382 paragraph(c)(3) indicates that an angel group that receives financing under this section shall use the amounts received to make investments in small business concerns with "more than 50% of the employees of which perform substantially all of their services in the United States **as of the date on which the investment is made.**" This indicates that once a financing has been made, any employee growth can be offshore. If so, then this taxpayer money could be used to finance foreign employee growth.

3. Sec 382 (d) – It is unclear whether this limitation is for each investment made under (g) or is the maximum any angel group can receive. The SBA should not be in a position of limiting the number of groups an angel investor can belong to.

4. Sec 382 (g) – This provision requires that at least half of an investment come from the angel group. It appears that the government funds flow to the angel group which then invests them. If so, is the entire investment made by the angel group with half of the funds supplied by the government? These mechanics are important as any repayment (under Sec 382 (h)) may be affected.

5. Sec 382 (h) – This provision limits repayment to proceeds from profits. However, oftentimes, a fund may receive some return of capital but no profit. In that instance, should the government receive no distribution?

SURETY BONDS

The SBA welcomes the suggested improvements in the surety bond program. Over the last few years participation in the program has diminished and while SBA has made a number of regulatory and administrative changes, there is a limit to our ability to effect change without statutory authority. I am glad that our recent regulatory effort is working, but we acknowledge the need for legislative changes, for example the increase in the surety bond level from two million dollars to three million dollars. This statutory limit has not been increased since the program's inception and is a concern that has been raised to the Administration several times.

VENTURE INVESTMENT

SBA has only recently seen the language concerning ownership interests of venture capital firms in small businesses. While the SBA encourages venture capital investment in small business we must object to this provision. The basic premise of small business size status (independent ownership and control) is circumvented by the provision, which would allow a large business to own and control several small businesses without affecting the size status of the businesses. Furthermore, concerns wholly owned by large businesses could compete for and obtain contracts set aside for small business concerns, as well as grants and other forms of assistance reserved to small businesses. This also represents a potential conflict with our recent efforts to address the misidentification of large firms as small businesses for federal procurement purposes.

Chairwoman Velazquez, the SBA is working diligently to strengthen its impact through the investment division and its programs, but we have tempered those efforts with prudence. We have increased our oversight function to address problems we have faced in the participating securities program. At the same time, we have worked to improve our relationship with the industry and to reach out to industry leadership to address issues and concerns, and work toward common solutions.

The SBA is actively seeking industry input on making the SBIC program more attractive to both fund managers and investors, and we believe the debenture program can have a substantial, positive impact on the Nation's communities. However, we firmly believe that the best and most equitable way to influence investment in small business in all communities is through sound, broad based tax and economic policy that encourages investment at all levels.

Thank you for the opportunity to testify before the Committee today and I look forward to any questions the Committee Members might wish to ask.